SUPREME COURT, U. S.
MAY

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-1152

PANHANDLE EASTERN PIPELINE COMPANY,
Petitioner,

vs.

RONALD F. DWYER, Director of Property Valuation of the State of Kansas, et al.,
Respondents.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF KANSAS

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No. 71-1152

PANHANDLE EASTERN PIPELINE COMPANY,
Petitioner,

vs.

RONALD F. DWYER, Director of Property Valuation of the State of Kansas, et al.,
Respondents.

MOTION TO DENY PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF KANSAS

Come now the Respondents and respectfully move the Court to deny the petition for writ of certiorari to the Supreme Court of Kansas in the above matter because it fails to show that the validity of any treaty or statute is drawn in question, and because it fails to show that any title, right, privilege or immunity of petitioner, specially set up or claimed under the Constitution of the United States or any statute

thereunder, has been infringed or denied by respondents or the Kansas Courts.

Respectfully submitted,

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GENERAL NATURE OF THE CASE

When this case was decided by the Supreme Court of Kansas on May 15, 1971, it was a forerunner of a series of litigated challenges by interstate utilities of the Kansas 1969 state assessment for ad valorem purposes, both by direct appeals, and by tax protest actions.

The original decision, *Panhandle Eastern Pipeline Co. v. Dwyer,* 207 Kan. 417, 485 . 2d 149, was decided, in a Johnson County direct appeal action, in favor of the state assessment by a Kansas Supreme Court divided four to three. *(A 1) The same day, another case, *Panhandle Eastern Pipeline Co. v. Herren,* 207 Kan. 400, 485 P. 2d 156, a Reno County tax protest case, was unanimously decided against the state and remanded on procedural grounds. The petitioner, Panhandle, filed motions for rehearing in both cases, and the motions both were sustained.

Meanwhile, Northern Natural Gas Co., had three appeals being readied for oral argument: *Northern Natural Gas Co. v. Dwyer,* 208 Kan. 337, a direct appeal from Pawnee County, and two tax protest cases, one from Rice County, *Northern Natural Gas Co. v. Williams,* 208 Kan. 407, from Rice County,

* References are made to pages in petitioner's appendix.

which had been tried on its merits, and one from Clay County, *Northern Natural Gas Co. v. Bender,* 208 Kan. 135, which had been decided on procedural grounds favorably to the state. Northern was granted a motion to accelerate the hearing to the fall docket.

The Northern Natural Gas Co. cases are now docketed before this Court, numbered 71-1104, 71-1105 and are being consolidated for motions and briefs.

The Kansas Supreme Court set all five of these cases for oral argument on the same day, September 21, 1971. Practically the entire day was devoted to these cases.

The Kansas Court later disposed of other of petitioner Panhandle's protest tax cases, one a consolidation of six county cases, *Panhandle Eastern Pipeline Co. v. Tieperman,* 208 Kan. 252, and *Panhandle Eastern Pipeline Co. v. Jones,* 208 Kan. 280, four county cases.

The Kansas Court also disposed of the rehearing of the Panhandle tax protest case in Reno County, 208 Kan. 304, by affirming its original decision, but modifying it. All of these cases were appeals with reference to procedure under K.S.A. 79-2005, the tax protest statute.

There would seem to be great importance to the point that, upon rehearing, one of the judges who dissented (A 17) in the Panhandle direct appeal decision, concurred with the majority on rehearing (A 20), leaving only two dissenting. But more, this same judge wrote the opinion for the majority in the Northern direct appeal from Pawnee County, to which there was but one dissent. This Northern decision (A 30) should be considered in connection with this Panhandle appeal, because substantially the state used the same appraisal practices and procedures on both valuations and assessments and applied the same statutes in the same tax year to utilities of a similar class. Furthermore, this same judge wrote the

opinion in the Northern Natural Gas Company tax protest case now before this court in Case #71-1105. (See Appendix of that case at page A 52).

There is no dispute as to the basic facts concerning the nature, extent and inventory of the physical property of petitioner, both system-wide and in Kansas. (A 3) Respondents have accepted the figures from Petitioner's rendition, both on the balance sheet and in the income statement. (A 3) It is agreed that the Kansas allocation percentage out of petitioner's total system value in 1969 is 29.47%.

The controversy arises because of the appraisal conclusions drawn from those facts, and the interpretation of Kansas statutes pertaining to ad valorem taxation when applied to those facts. Also, there is a question whether the 1968 Kansas Sales Ratio Study, standing alone, is a conclusive indicator of the 1969 level of assessment of real estate in Kansas in relation to the market value of Kansas real estate in 1969.

THE ISSUES

1. **Have respondents, in the state assessment of petitioner's Kansas property for 1969 ad valorem tax, used an appraisal that followed the Kansas statutory listed factors and criteria? Petitioner charges that respondents used only the undepreciated original cost, and contends that, instead, the sole criteria to determine the value of petitioner's property should be original cost, less the straight-line depreciation, or rate base, and capitalization of the net income allowed by FPC on rate base.**

On this issue, the Kansas Board of Tax Appeals (A 102), the Kansas District Court (A 115) and the Kansas Supreme Court (A 11) found, after examining respondents' appraisal, that all applicable statutory factors had been followed.

2. Is the 5% rate, selected by respondents to capitalize petitioner's FPC "net operating income," unreasonably low?

Respondents contend that 5% is a reasonable rate after consideration of all of the financial facts as revealed in petitioner's rendition. The Kansas Board of Tax Appeals (A 102), the Kansas District Court (A 112) and the Kansas Supreme Court (A 11) found that the 5% rate was reasonable.

3. Does the 1968 Kansas Sales Ratio Study, standing alone, conclusively prove the level of the 1969 Kansas assessment of real estate in relation to the *justifiable or fair market value of such real estate?

Again, at all three levels of the Kansas judiciary process, it was found against the contention of petitioner. (A 12, 102, 119)

THE COST APPROACH

Since petitioner is undertaking to use a single cost approach — original cost less FPC straight-line depreciation or rate base, petitioner undertakes to construe respondents' appraisal to have used also a single cost approach — undepreciated original cost.

Respondents' appraisal has been in the record, as State's Exhibit B, at all three levels before the Board, District Court, and Supreme Court of Kansas. It shows that three cost approaches were used to indicate values as of assessment date, January 1, 1969: a) Original Cost — $186,928,324; b) Original Cost less depreciation — $123,523,501; and c) Reproduction Cost less depreciation — $196,888,770. In the Reproduction

* "True Value," "justifiable value," "actual value in money" all mean fair and reasonable value for taxation purposes. *Board of County Commissioners v. Brookover*, 198 Kan. 70, 77, 422 P. 2d 906 (1967).

Approach, respondents used the Handy Whitman Index for trending purposes, bringing the 1968 trended cost to assessment date, and then deducted 3½% for depreciation. After that, new plant in 1968 and materials and supplies were added. (*R 373) On the next page, respondents preformed a capitalization of income approach to value, one on the 1968 income and the other on a three year average income, and respondents used the latter, noting that since 1964 revealed an increase of over 35% in net operating income and that three years average income should be used to avoid radical adjustments of income due to plant growth. Respondents then applied a 5% capitalization rate, which produced an indicator of value of $176,313,470. (R 374)

Respondents' appraisal contained a correlation of value indicators and further gave a percentage weight to those approaches used, as follows:

Income approach	20%
Original cost approach	40%
Reproduction cost less depreciation	40%

Respondents then reached an appraisal conclusion of market value as $187,676,054. (R 372)

Petitioner has failed to tell the whole story. The facts are that the first 1969 notice went out to petitioner as a valuation of $187,676,054 with an assessed value of $56,302,800. Petitioner asked for a hearing before the Director and complained that the valuation was excessive. Following that hearing, the respondent Director did grant petitioner a slight reduction on May 28, 1969, and did reduce petitioner's valuation to $186,928,324 and an assessed value of $56,078,497. He did this by drawing a line through the first set of figures, and

* Record references are to the Record on Appeal before the Kansas Supreme Court, which is part of the certified record before this court.

then writing in the second set. (R 202, Taxpayer's Exhibit 1, and R 377, State's Exhibit C)

Not being satisfied with such reduction, petitioner appealed. Upon trial before the Board of Tax Appeals, petitioner called the respondent Director to the stand and questioned him about his having made his final figures the same as original cost. He answered: "It may have ended up that that, it wasn't the purpose. In other words, I didn't just take a certain percent of original cost." (R 59) The Director had given original cost 40% weight in the appraisal, and it was in the middle of the value indicators. (R 372)

The respondent Director later testified, when asked if it were possible to come out at original cost by using the trended and depreciation methods. He answered: "This method will generally tend to bring a value by appreciation and depreciation in a close proximity to what the original investment figure for the company is." (R 64). He then testified that he had checked this out with appraisals of other companies as well as Panhandle Eastern.

The testimony of the staff appraiser confirmed the director's testimony. He explained his appraisal and the change after the hearing. (R 162). He objected to FPC rate base being used to set value for taxation. He said: "If it were, there would be no need for appraisal of that property." (R 165) Later he identified State's Exhibit E (R 379) on which he had compared the assessments of petitioner, Northern Natural and several other similar utilities. He used both Handy Whitman Index and the Engineering News Record. He testified that the trended approach of appreciation and depreciation comes out "very close" to original cost. (R 178)

Petitioner's brief contends that original cost is not one of the factors specified by K.S.A. 79-503. Petitioner just refuses to look at "(e) cost of reproduction or improvements." Cost

of improvements is original cost. Petitioner is the same as Northern Natural Gas, of whom the Kansas Supreme Court said: "Apparently Northern would like to ignore this factor." (A 199 of Appendix in case #71-1105) Petitioner valuation witness here declined to compute any trended reproduction cost new less depreciation, even though it was a statutory factor, an accepted appraisal practice and the MAI manual called for it. (R 132-135)

It would appear that the main difference between the parties is that respondents contend that both appreciation and depreciation must be considered to arrive at justifiable and fair market value on January 1, assessment date.

But petitioner has undertaken to be valued only on rate base original cost less the FPC straight-line depreciation. There is the rub.

The required FPC "depreciation expense" of 3½% annually out of gross revenues allows petitioner to recapture in full, in slightly over 28½ years, its entire plant investment. (A 3) Petitioner admits in the record it has plant in service in Kansas that is 38 years old on assessment date. (R 33)

It is reasonable that respondents refuse to join petitioner and the FPC in pretending that this 38 year old property, still in service, has no market value for tax purposes. No well informed and prudent purchaser would discard this fact. In Kansas it is traditional to value property at some value for ad valorem purposes, regardless of age, if it is still in use. A house or store may be 100 years old, but, if it is still in use, it is appraised and taxed. There is no "straight-line" depreciation whereby property can lose its entire value while still in use. The principle of equality and uniformity of tax burden compels respondents to treat petitioner and other utilities the same as other Kansas taxpayers.

THE INCOME APPROACH

Respondents also ran an income approach by capitalizing at 5%. Petitioner claims such rate is unreasonably low and produces "a grossly excessive valuation." Petitioner's witness used a capitalization rate of 7%, which he derived from the money and bond markets, including common stock equity discount rates. (R 107). Since both parties were using the same income figures, the rate was the main issue.

Respondents explained the adoption of a 5% rate after scrutinizing the income stream that was being capitalized. Before the Board of Tax Appeals, the District Court and the Kansas Supreme Court, respondents kept pointing to the excessive recapture privileges granted by FPC in that petitioner was allowed in 1968 to take out of gross revenues in disposable cash the sum of $19,776,957. This sum was deducted on its FPC income statement on line 403 before determining "net operating income." (R 205) And this had been true year after year after year. Appellant is by its own records a half billion dollar utility. (R 204) Therefore, each year it is recapturing in cash 3½%. It is a positive guaranteed FPC recapture PRIOR to the demise of the service plant life, and this would be a highly sensitive point to a purchaser in the open market, and certainly it is a factor that should be considered by an appraiser striving to arrive at fair market value by following accepted appraisal practices.

The Court has on several occasions frowned upon excessive charges to operating expenses for depreciation reserves. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 606, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Lindheimer v. Illinois Tel. Co.*, 292 U.S. 151, 168, 169, 54 S.Ct. 658, 78 L.Ed. 1182 (1933); *Board of Public Utility Comm. v. N.Y. Tel. Co.*, 271 U.S. 23, 30, 46 S.Ct. 363, 70 L.Ed. 805 (1925); *Louisiana Ry.*

Comm. v. Cumberland Tel. & Tel. Co., 212 U.S. 414, 424, 425, 29 S.Ct. 357, 53 L.Ed. 577 (1908).

Before the Board of Tax Appeals, the District Court and the Supreme Court of Kansas, respondents pointed to the fact that before arriving at "net operating income" petitioner in 1968 deducted out of gross revenues the sum of $3,691,400.00, on line 409, to pay for all income taxes, state and federal. (R 205)

Respondents contend that to follow proper appraisal practice it is necessary to know and to examine the nature and character of the income stream about to be capitalized. Here, a purchaser for value in money would recognize he would get a return OF investment, as well as return ON investment, and all would be state and federal tax FREE, and so he would accept a lower rate of return ON investment. That really would be in the nature of a tax free interest rate, as might be expected from a municipal bond. Five per cent would have been fair enough on January 1, 1969.

Perhaps, one point should be explained. One dissenting judge commented that it was an "arbitrary" choice for the respondent Director to use a 5% capitalization rate in the Panhandle case and a 5.5% rate in the Northern case. (A 24) It is just as "arbitrary" as the exercise of judgment by the Federal Power Commission in setting a rate of return of 6⅝% for Panhandle (A 3), while at the same time and in the same year setting a rate of 6.8% for Northern. (A 43)

It is just as "arbitrary" as the valuation witnesses of these very utilities selecting a capitalization rate of 7% in Panhandle (A 10) and an 8½% rate in Northern. (A 52) The similarity of the difference in the rates of the two companies by all exercising appraisal judgment should be noted.

There is another point that merits comment with respect to the selection of a 5% capitalization rate by respondents.

It is the sale of Great Lakes Pipeline to Williams Brothers Co. Respondents used this sale, not market data to indicate the system value of Panhandle, but to prove a) that a knowledgeable buyer would pay more than rate base for a regulated pipeline; b) that such buyer would accept less than 5% current rate of return ON his investment; and c) that the rate of return on investment in a regulated company can increase in years subsequent to the purchase.

Respondents introduced its worksheet on this sale into evidence. (Exhibit D, R 378) Testimony concerning it is in the record. (R 165-172) Petitioner's own witness admitted it is proper appraisal procedure to research the market place to see the rate of return on investment buyers expect. (R 138-139)

It is respectfully submitted that there is in the record exhibits and testimony sufficient to justify the reasonableness by respondents in making their income approach to value of petitioner's property.

THE SALES RATIO STUDY

Whether the 1968 Sales Ratio Study (R 206-239, Exhibit 4) can be used for tax assessment appraisal and apportionment purposes is critical in this appeal. Petitioner not only wants its appraisal to be adopted as the 100% justifiable value, but that in addition the Court order an allocation of such reduced value, not at 30% (R 4), but at the median sales ratio study percentages for each county in Kansas in which petitioner has installations. (R 11)

Petitioner's theory is that sales and justifiable value are the same and equal. (R 62) Here lies a basic issue upon which this appeal is predicated.

Respondent Director testified that it had been the policy of his office not to use the Sales Ratio Study for tax appraisal

purposes, and that this policy had recently been enacted into law. (R 63). The Director testified that the Ratio Study was an annual sampling of sales of real estate which varied among counties from five-tenths of one per cent to four and one-half per cent of the total parcels within the county. (R 62-63)

It is the Director's position that the Kansas Legislature did not intend the Ratio Study to be used as an appraisal of justifiable or fair market value for tax appraisal purposes; that the Ratio Study has a special statutory function, and that in the 1969 sessions the legislature refined the classifications and subclassifications of the Ratio Study so that it can better serve its specific statutory function. (K.S.A. 79-503, 79-1436a, 79-1436b copies of which laws are attached to this response, see Appendix hereto, pages 29-32) The 1969 amendments affect the 1969 Sales Ratio Study and the use of that study.

Petitioner offered no evidence in support of the theory that the Ratio Study should be equated with justifiable value except the testimony of Dr. Francis Woodard that he had helped prepare it. (R 70-71) Dr. Woodard does not use the words "justifiable or fair market value" in relation to the Ratio Study. He repeatedly refers to the Ratio Study as the "Sales" ratio study. (R 70-82) He does declare the accuracy of the sales ratio study. (R 73)

But the Director has never denied the accuracy of the sales ratio study. He would not do so, having directed the compilation and publication of the study. Where the controversy arises is when petitioner wants to equate the median or middle ratio card to ALL the land in a county, including petitioner as a utility.

COEFFICIENT OF DEVIATION

K.S.A. 79-1436b, says that: "In the taxable years commencing after December 31, 1971, whenever the Director of

Property Valuation shall determine that the coefficient of deviation of any one classification or subclassification of property in a county, as shown by the ratio studies, is greater than 20, he is authorized and DIRECTED to order all property within such classification or subclassification within such county to be reappraised."

Coefficient of Deviation was actually not a "new" term. The 1968 Ratio Study, Exhibit 4, defines the term (R 211) and then (R 224-232) spells out the coefficient of deviation for every Kansas county. This is petitioner's exhibit. This just follows former surveys. The coefficient of deviation is the goal of these surveys. Why? Because this is what shows the need of reappraisal. It shows that the median is not stable. It shows need to check appraisal of a classification or subclassification. It does NOT show that everybody, including utilities, should be equalized with the median.

Every Ratio Study reflects the number of ratio study cards used. (R 216-219, Exhibit 4) This is done by county. It is at once apparent that these cards in the various counties range from less than 5% to more than 120% when the sales price is compared to the assessed valuation.

The established "middle card" is the "median." The ratio of that card is then attributed to that county.

Now, "coefficient of deviation" is a further computation. It is the percent deviation of each sale to the median sale; totaled, and then divided by the number of sales; expressed in percent as an average deviation; then divided by the percent of the median sale. The coefficient of deviation denotes only the degree of equality or non-equality for that particular class of property, comparing the assessed value only to raw sales price. If the coefficient of deviation is more than 20, then the legislature has declared a breaking point and directed a reappraisal in K.S.A. 79-1436b, after December 31, 1971.

This is the only statute that says how the ratio study shall be used in the tax appraisal process. *It is a reappraisal tool.*

The Supreme Court of Kansas recognized, even before it was specifically set out in the statutes, that the ratio study served as a sound basis for making an order of reappraisal. *Board of County Comm. v. Brookover,* 198 Kan. 70, Syl. #10, 422 P. 2d 906 (1967).

The failure of the Kansas Legislature to change the ratio study laws after it received the Brookover judicial construction amounts to legislative approval of the court's interpretation. *McIver v. State Highway Comm.,* 198 Kan. 678, 426 P. 2d 118 (1967). The subsequent enactment in 1969 of K.S.A. 79-1436b stating that the specific use of the ratio study shall be for reappraisal purposes confirms legislative approval of Brookover.

When the legislature adds something to an existing statute there is a presumption that there was an intention to supply some want, to fill some deficiency, to add something to make existing legislation more complete, to clarify legislative intent. *Consumers Co-op Ass'n. v. State Commission of Revenue and Taxation,* 174 Kan. 461, 256 P. 2d 850 (1953).

Where the Legislature states its interpretation of language then or previously used in a statute, that interpretation is entitled to great weight. *Richardson v. Kansas Soldiers' Compensation Board,* 150 Kan. 343, 92 P. 2d 114 (1939).

Where a former statute is amended or a doubtful meaning of a former statute rendered certain by subsequent legislation, such amendment or recent legislation is strong evidence of what the legislature intended by the first statute. *Kucera v. State,* 160 Kan. 624, 164 P. 2d 115 (1945).

Early in the 1969 session of the Kansas Legislature K.S.A. 79-503 was amended. That amendment is set forth in an appen-

dix attached to this response. (P. 29) This law was enacted prior to the 1969 valuation and assessment of petitioner's property by respondent, and became effective before the first hearing thereon before the Kansas Board of Tax Appeals.

The Kansas Legislature gave positive evidence of legislative intent with these words concerning the Sales Ratio Study:

> "Sales in and of themselves shall not be the sole criteria of fair market value but shall be used in connection with cost, income and such other factors as may be appropriate including but not by way of exclusion:"

The statute then recites the factors listed in the 1968 law, including (e), but added to (j) are these words, "The ratio study shall not be used as an appraisal for appraisal purposes."

There is another important addition by the 1969 amendment to K.S.A. 79-503. It is the classification of real property into two major classes of urban and rural, and then dividing rural into six subclasses listed therein. This refinement of the rural property was needed to clarify much confusion in the Rural Sales Ratio. This fact is mentioned by the Kansas Supreme Court in the Rice County decision. (A 62-64)

To complete the legislative plan, the 1969 Kansas Legislature also passed K.S.A. 79-1436a and 79-1436b, which are also in the appendix attached to this response. (P. 29) They establish that the ratio study must be used as a reappraisal indicator. But petitioner never was interested in this case in a reappraisal of any particular county. Even when challenged to file a complaint under K.S.A. 79-1413a, a reappraisal statute, even when challenged to bring in local county officials, petitioner declined. (R 40)

There is a peculiar consistency between petitioner wanting to be appraised on a single factor – rate base, and then wanting a further reduction in value to another single factor –

the median sales ratio card. This is consistent use of single factors in achieving justifiable or market value in money contrary to Kansas legislative intent as prescribed in K.S.A. 79-503.

HISTORY OF UTILITY RATE VALUATION AND REGULATION

Valuation for rate purposes of public utilities has had an interesting and involved history of development in this country. *Munn v. Illinois*, 94 U.S. 113, 124, 125, 24 L.Ed. 77 (1876); *Smyth v. Ames*, 169 U.S. 466, 547, 18 S.Ct. 418, 42 L.Ed. 819 (1898); *Knoxville v. Knoxville Water Co.*, 212 U.S. 1, 13, 14, 29 S.Ct. 148, 53 L.Ed. 371 (1909), and *Willcox v. Consolidated Gas Co.*, 212 U.S. 19, 29 S.Ct. 192, 53 L.Ed. 382 (1909); *Southwestern Bell Tel. Co. v. Public Service Comm.*, 262 U.S. 276, 43 S.Ct. 544, 67 L.Ed. 981 (1922); *Los Angeles Gas Co. v. R.R. Comm.*, 289 U.S. 287, 53 S.Ct. 637, 77 L.Ed. 1180 (1932); *Driscoll v. Edison L. & P. Co.*, 307 U.S. 104, 59 S.Ct. 715, 83 L.Ed. 1134 (1938); *Natural Gas Pipeline Co. v. F.P.C.*, 315 U.S. 575, 62 S.Ct. 736, 86 L.Ed. 1037 (1941); *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591, 602, 63 S.Ct. 281, 88 L.Ed. 333 (1944); *Permian Basin Area Rate Cases*, 390 U.S. 747, 757, 20 L.Ed. 2d 312, 88 S.Ct. 1344 (1967).

In this evolution from "fair value" as undepreciated original cost, through "reproduction new, less depreciation" with a recapture feature, the "fair return" concept, and finally "just and reasonable end result," valuation for rate purposes has never included the usual and accepted appraisal practices of reaching "fair market value," needed for ad valorem taxation.

As Justice Jackson said in a concurring opinion in the Hope case:

> "The service one renders to society in the gas business is measured by what he gets out of the ground, not by what he puts into it, and there is little more relation between the investment and the results than in a game of poker." (p. 649)

The above cases were cited and followed by the Kansas Supreme Court in *Southwestern Bell Tel. Co. v. State Corporation Commission*, 192 Kan. 39, 69, 386 P. 2d 515 (1963). In that case, the Kansas Court said: "Reasonable value for rate-making purposes is not the literal present fair value for each and every purpose, but is the reasonable value as that term is understood for the purpose of determining a fair and reasonable return. In this respect, the term "reasonable value" as used in G.S. 1949, 66-128, has a connotation peculiar to rate proceedings." (p. 65)

Having failed in getting the Kansas Supreme Court or the United States Supreme Court to determine rate base on the fair market value appraisal principles, the utilities in this volume of litigation have tried the only other available tact: to make rate base synonymous with market value. If rate base equals market value, then the reverse (and an equation is a two way street) is that market value equals rate base. This is the explanation of this whole legal war of some 600 various law suits in Kansas Courts.

VALUATION OF UTILITIES FOR AD VALOREM TAX

The growth and development of the imposition of state property tax upon interstate utilities had had even a longer history than the rate cases. In doing so, there has not been a commingling in these cases of the true cash or market value needed for property tax and the value used for rate base, as is attempted in this appeal.

The United States Supreme Court approval of state valuation and tax assessment of interstate utilities possibly commenced with *Philadelphia, Wilmington and Baltimore Ry. Co. v. Maryland,* 10 Howard 376, 394, 13 L.Ed. 461 (1850). The opinion written by Chief Justice Taney held that there was no exemption of such corporations or reason why their property, real and personal, should not bear its share of the state's public burden.

The first Kansas case was *Missouri Ry. Co. v. Morris,* 7 Kan. 210 (1871). Justice Valentine wrote the opinion which upheld an 1869 Kansas law establishing a Board of County Clerks to value and assess railroad property in Kansas on a whole system basis, and then apportion it to the counties on the basis of miles of track in each county. This apportionment is still the law today. K.S.A. 79-606. Justice Brewer was a member of the Kansas Supreme Court when this decision was handed down. Here is some interesting language in that decision:

> "The constitution does not require that the MANNER OR MODE OF ASSESSING AND TAXING property, or the manner and mode of COLLECTING THE TAXES, shall be equal and uniform; but it simply requires that all property shall be assessed and taxed at AN EQUAL AND UNIFORM RATE." (pp. 221-222, Emphasis by the Court)
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> "As we have already stated, a railroad is an entire thing, and cannot well be valued or assessed except as a whole. Hence the provision of the act that provides for taking the entire value of the road and dividing it up by a certain rule for each county, township, etc., through which the road runs, is, at least, a reasonable rule, and, except in rare cases, is probably as good a rule for deter-

mining the true value of each particular portion of the road as any other rule that could be adopted." (pp. 221-223)

This *Missouri River Ry. Kansas* case (pp. 223-224) was cited to the United States Supreme Court in the *State Railroad Tax Cases*, 92 U.S. 575, 23 L.Ed. 663 (1875), by the Attorney General of Illinois in support of an 1872 law. The issue was whether an interstate railroad could be valued and assessed as a unit and then allocated to taxing districts on the basis of miles of track. That decision held:

"It may well be doubted whether any better mode of determining the value of that portion of the track within any one county has been devised than to ascertain the value of the whole road, and apportion the value within the county by its relative length to the whole." (p. 608)

* * *

"But suppose it were otherwise; perfect equality and perfect uniformity of taxation as regards individuals or corporations, or the different classes of property subject to taxation, is a dream unrealized. It may be admitted that the system which most nearly attains this is the best. But the most complete system which can be devised, must, when we consider the immense variety of subjects which it necessarily embraces, be imperfect. And when we come to its application to the property of all citizens, and of those who are not citizens, in all the localities of a large State like Illinois, the application being made by men whose judgments and opinions must vary as they are affected by all the circumstances brought to bear upon each individual, the result must inevitably partake largely of the imperfection of human nature, and of the evidence on which human judgment is founded." (Citing cases) (p. 612)

The unit system of valuating interstate utilities was firmly established, where a state commission was trying to arrive at "actual cash value," by the decision of *Cleveland & C. v. Backus*, 154 U.S. 439, 14 S.Ct. 1122, 38 L.Ed. 1041 (1895). Here are some quotations from that opinion written by Justice Brewer:

> "It is the aggregate of those values plus that arising from a connected operation of the whole, and each part of the road contributes not merely the value arising from its independent operation, but its mileage proportion of that flowing from a continuous and connected operation of the whole." (p. 444)
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> "The rule of property taxation is that the value of the property is the basis of taxation. It does not mean a tax upon the earnings which the property makes, nor for the privilege of using the property, but rests solely upon the value. But the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use. The amount and profitable character of such use determines the value, and if property is taxed at its actual cash value it is taxed upon something which is created by the uses to which it is put." (p. 445)

Justice Brewer established even more firmly the unit system of valuing utilities and factors of ad valorem tax valuation to be considered in *Adams Express Co. v. Ohio*, 166 U.S. 185, 17 S.Ct. 604, 41 L.Ed. 965 (1896):

> "Now, it is a cardinal rule which should never be forgotten that whatever property is worth for the purposes of income and sale it is also worth for purposes of taxation." (p. 220)
>
> • • •

"Suppose an express company is incorporated to transact business within the limits of a State, and does business only within such limits, and for the purpose of transacting that business purchases and holds a few thousand of dollars' worth of horses and wagons, and yet it so meets the wants of the people dwelling in that State, so uses the tangible property which it possesses, so transacts business therein that its stock becomes in the markets of the State of the actual cash value of hundreds of thousands of dollars. To the owners thereof, for the purposes of income and sale, the corporate property is worth hundreds of thousands of dollars. Does substance of right require that it shall pay taxes only upon the thousands of dollars of tangible property which it possesses? Accumulated wealth will laugh at the crudity of taxing laws which reach only the one and ignore the other, while they who own tangible property, not organized into a single producing plant, will feel the injustice of a system which so misplaces the burden of taxation. . . . But if the State comprehends all property in its scheme of taxation, then the good will of an organized and established industry must be recognized as a thing of value. The capital stock of a corporation and the shares in a joint stock company represent not only the tangible property, but also the intangible, including therein all corporate franchises and all contracts, privileges and good will of the concern." (p. 221)

In a later decision, the U.S. Supreme Court reaffirmed that all property of a utility should be considered for tax value which augments value by reason of a connected operation of the whole and enhances its value. The state may use and employ any appropriate means of reaching its actual or full value as part of a going concern. *Pullman Co. v. Richardson*, 261 U.S. 330, 43 S.Ct. 366, 67 L.Ed. 682 (1922). Here are excerpts of that decision:

"The state court holds that the tax is not a tax on gross receipts as such, but is in both name and essence a tax on property within the State, and that it is computed with reference to the gross receipts only as a means of adjusting it to the real value of the property in the relation in which the same is used. . . .

"A state can neither tax the act of engaging in interstate commerce nor lay a tax on gross receipts therefrom. In either case the tax would be a restraint or burden on such commerce and its imposition an invasion of the power of regulation confided to Congress by the commerce clause of the Constitution. (Citing cases)

"The rule is otherwise with property used in interstate commerce. A State within whose limits such property is permanently located or commonly used may tax it. (Citing cases)

"And, if the property be part of a system and have an augmented value by reason of a connected operation of the whole, it may be taxed according to its value as part of the system, although the other parts be outside the State; – in other words, the tax may be made to cover the enhanced value which comes to the property in the State through its organic relations to the system. (Citing cases)

"In taxing property so situated and used a State may select and employ any appropriate means of reaching its actual or full value as part of a going concern; – such as treating the gross receipts from its use in both intrastate and interstate commerce as an index or measure of its value; – and if the means do not involve any discrimination against interstate commerce and the tax amounts to no more than what would be legitimate as an ordinary tax upon the property, valued with reference to its use, the tax is not open to attack as restraining or burdening such commerce." (Citing cases) (pp. 337-339)

In 1939 a case arising from Tennessee presented a contention that the assessment of utilities by a state commission, when all other property in the state was valued for taxation by local assessors, was discriminatory because local assessors were far less than true value. The Tennessee Supreme Court held the evidence insufficient to overcome the presumption that the Board had equalized assessments in accordance with the command of state law. The claim was also made that the commission assessment was so greatly excessive of full value as to violate the 14th Amendment. Here are the same two issues that confront the Court on this appeal.

Here are excerpts from that case:

> "This Court has previously had occasion to advert to the narrow and sometimes cramping provision of these state uniformity clauses, and has left no doubt that their inflexible restrictions upon the taxing powers of the state were not to be insinuated into the meritorious conception of equality which alone the Equal Protection Clause was designed to assure. (Citing cases)
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> "That the states may classify property for taxation; may set up different modes of assessment, valuation and collection; may tax some kinds of property at higher rates than others; and in making all these differentiations may treat railroads and other utilities with that separateness which their distinctive characteristics and functions in society make appropriate – these are among the commonplaces of taxation and of constitutional law. (Citing cases)
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> "Since, so far as the Federal Constitution is concerned, a state can put railroad property into one pigeonhole and other property into another, the only question relevant for us is whether the state has done so. If the discrimination of which the Railway complains had been formally

written into the statutes of Tennessee, challenge to its constitutionality would be frivolous. If the state supreme court had construed the requirement of uniformity in the Tennessee Constitution so as to permit recognition of these diversities, no appeal could successfully be made to the Fourteenth Amendment. . . .

"The Equal Protection Clause did not write any empty formalism into the Constitution. Deeply embedded traditional ways of carrying out state policy, such as those of which petitioner complains, are often tougher and truer law than the dead words of the written text. So we are of opinion that such a discrimination, not invidious but long-sanctioned and indeed conventional, would not be offensive to the Fourteenth Amendment simply because Tennessee had reached it by a circuitous road. It is not the Fourteenth Amendment's function to uproot systems of taxation. Inseparable from the state's tradition of fiscal administration and ingrained in the habits of its people. . . .

"The argument basically derives from the fact that the Commission's valuation of petitioner's system was the same as that for the previous biennium, although numerous adverse economic factors are alleged to have greatly reduced the property's worth. But railroads, unlike farms and city lots and stocks and bonds, are not objects of exchange. The very notion of a 'full cash value' for a railroad is in many respects artificial. See 1 Bonbright, The Valuation of Property, pp. 511-632. Whatever may be the pretenses of exactitude in determining such a 'value,' to claim for it 'scientific' validity, is to employ the term in its loosest sense. (Citing cases) Thorough canvass by the state courts found no justification for upsetting the determination of the Commission, and we could scarcely find warrant in the record for doing so.

But even assuming that there was an over-assessment, constitutional invalidity would not follow.

"We conclude, therefore, that the Commission's over-assessment of petitioner's property, if over-assessment there was, constitutes no deprivation of any right under the Federal Constitution." *Nashville & C. Ry. v. Browning*, 310 U.S. 362, 368, 369, 370, 371, 60 S.Ct. 968, 84 L.Ed. 1254 (1939).

The most recent view of the United States Supreme Court on this subject is reflected in the dismissal of an appeal from the Supreme Court of Arizona for want of a substantial federal question in *Apache v. A.T.S.F. Ry. Co.*, 106 Ariz. 356, 476 P. 2d 657, 401 U.S. 1005, 28 L.Ed. 2d 542, 91 S.Ct. 1257.

The allegation was that the railway taxpayer was discriminated against because the Arizona legislature taxed some at 60%, some 40%, some 25%, and some 18% of value. The state Supreme Court upheld this classification, stating that groups specifically benefiting or specially burdening society may be required to pay additional taxes. It was held that placing all railroad companies in a class of property to be assessed at 60% of full cash value, while placing property of other taxpayers to be taxed at a less percentage of value did not violate constitutional provisions that all taxes be uniformly assessed on the same class of property. It was further held that this did not place an undue burden on interstate commerce.

In all of this litigation by utilities before the Kansas Supreme Court, the only one where the utility briefed and argued the constitutional question of burdening interstate commerce was in *Northern Natural Gas Company v. Bender*, now docketed as case #71-1104 and 71-1105. The Kansas Court held in syllabus #5 that the provisions of the state and federal constitutions were not violated "so long as all properties are assessed on the same basis, are measured by the

same yardstick and appropriate appeal provisions are provided for their review." (Appendix of 71-1105, A 285). In the body of the decisions the Kansas Court pointed the procedure to raise the question as to burden on interstate commerce, adding that the court was able to perceive no burden on interstate commerce.

UNIFORMITY

The really generalized definition of "value" that appears in the law books is that of Justice Holmes in *International Harvestor v. Kentucky,* 234 U.S. 216, 222, 34 S.Ct. 853, 58 L.Ed. 1284 (1913). He said:

> "Value is the effect in exchange of the relative social desire for compared objects expressed in terms of a common denominator."

There is the key: "expressed in terms of a common denominator."

We are here involved in a litigation as to a proper valuation for ad valorem tax purposes. We know the common denominator: "market value." How can this be applied to a public utility? How can it be so applied that it will be equal and uniform, not only between utilities, but with all other Kansas property owners who must be valued on the basis of market value? Have the rules of equality and uniformity, between utilities themselves, and between utilities and locally assessed taxpayers, been met? Those are the questions.

The second key is: *the results.* Has the objective been reached of "market value" in appellee's appraisal of appellant's property? If he has, and if he has followed generally those statutory valuation principles being used on other Kansas property owners which are applicable to utilities, he has at least approximated an acceptable degree of equality and uniformity.

Justice Butler spells it out this way:

> "The ascertainment of the value of a railway system is not a matter of arithmetical calculation and is not governed by any fixed and definite rule. Facts of great variety and number, exact and those that are approximations, forecasts based on probabilities and contingencies have bearing and properly may be taken into account to guide judgment in determining what is the money equivalent – the actual value – of the property." (Citing many cases) *Rowley v. Chicago & N. W. Ry.*, 293 U.S. 102, 109, 55 S.Ct. 55, 79 L.Ed. 222 (1933).

Cooley on Taxation, Vol. 1, Chap. 6, Sec. 299 expresses it this way:

> " . . . However, the generally accepted rule is that the uniformity required is uniformity in results and not uniformity in the methods of taxation. A uniformity method of valuation is not required but only that the regulations shall secure a just valuation of all the property taxed. The equality and uniformity rule does not require the same method of ascertaining the value of different property for the purpose of taxation. The property which is the subject of taxation is so various and different in its characteristics and conditions that a fixed and unvarying rule for ascertaining its value would be ineffective, and might easily produce a more unjust valuation than different methods and agencies created expressly for the purpose of adaption to the different classes of property sought to be valued."

CONCLUSIONS

1. If a part of petitioner's system is in operation within Kansas and augments the market or justifiable value of the system, even though it may be in use more than 29 years,

it is a real part of the "going concern" of petitioner's system and Kansas is entitled to count that part for ad valorem tax valuation purposes, F.P.C. designation as totally depreciated notwithstanding.

2. It is inaccurate to accuse respondents of *appraising* petitioner's property by adopting undepreciated original cost as the sole basis, when the record clearly shows that respondent's appraisal gave 40% weight to original cost and 40% weight to a reproduction new less depreciation approach and 20% to the income approach, and the appraisal figure was reduced to the level of original cost after a hearing.

3. The use of "rate base" or original cost less F.P.C. straight-line depreciation, as the sole criteria to be used in determining the justifiable or market value of petitioner's utility, would establish a fixed and unvarying rule for utilities in Kansas and would be an injustice to many Kansas taxpayers who could not enjoy the benefit of such a rule.

4. There exists reasonable, independent, adequate, nonfederal grounds to support the appraisal of petitioner's property in Kansas for 1971 ad valorem taxation, and for the judgments of the Kansas Board of Tax Appeals, the Kansas District Court and the Kansas Supreme Court in affirming that valuation and assessment thereunder.

5. It is respectfully submitted that the petition for writ of Certiorari be denied.

Respectfully submitted,

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APPENDIX

K.S.A. 79-503. Fair market value in money, how determined; factors; classification of property; forms; area meetings to develop guidelines. Fair market value in money shall mean the amount of money that a well informed buyer is justified in paying and a well informed seller is justified in accepting, assuming that the parties thereto are acting without undue compulsion and that the property has been offered at the market place for a reasonable length of time. Sales in and of themselves shall not be the sole criteria of fair market value but shall be used in connection with cost, income and such other factors as may be appropriate including but not by way of exclusion:

(*a*) The proper classification of lands and improvements;

(*b*) the size thereof;

(*c*) the effect of location on value;

(*d*) depreciation, including physical deterioration or functional, economic or social obsolescence;

(*e*) cost of reproduction or improvements;

(*f*) productivity;

(*g*) earning capacity as indicated by lease price or by capitalization of net income;

(*h*) rental or reasonable rental values;

(*i*) sale value on open market with due allowance to abnormal inflationary factors influencing such values; and

(*j*) comparison with value of other property of known or recognized value. The ratio study shall not be used as an appraisal for appraisal purposes.

In each county of the state the county assessing officer shall

on January 1; 1971, and on January 1 of each year thereafter classify and subclassify all real estate into the following classes:

A. Urban property

1. *Residential.* Residential property shall include land and improvements thereon used or if unoccupied designed for use as a single family dwelling or home.

2. *Multifamily.* Multifamily property shall include land and improvements thereon containing independent dwelling units for two or more families in a single structure.

3. *Commercial.* Commercial property shall include land and improvements thereon concerned with all activities of business or trade engaged in for the purpose of producing income but shall not include industrial property.

4. *Industrial.* Industrial property shall include land and improvements thereon used for the conversion of materials into finished manufactured products or for the purpose of warehouses or minor processing plants.

5. *Vacant lots.* Vacant lots shall include unimproved property which has been platted into lots and blocks.

B. Rural property

1. *Agricultural investment.* Agricultural investment shall include those properties presently used and operated as units with a source of economic life from the production of agricultural products that originate from land productivity.

2. *Agricultural noninvestment.* Agricultural noninvestment shall include those properties presently used and operated as noneconomic agricultural units upon which some agricultural goods are produced but the primary source of value of which is as a rural home with cash needs derived from other than nonagricultural sources.

3. *Ho ae sites.* Home sites shall include those properties that provide residential uses only with rural atmosphère .that permits the use of horses, pets, etc. but do not produce goods or income from agricultural products.

4. *Planned subdivisions.* Planned subdivisions shall include those properties planned and platted for community residential uses, developed and sold as a commodity through wide mass sales exposure.

5. *Spot industrial and commercial.* Spot industrial and commercial properties shall include land and rural areas developed for spot industrial and commercial uses at selected locations to satisfy isolation or decentralized needs of industrial plants.

6. *Recreational.* Recreational properties shall include properties located in rural areas where lakes, streams, forest and mountain terrain and physical characteristics permit recreational uses of the commercial nature so that the source of economic life are from commercial improvements and not based on land capabilities and associated productivity responses.

The appraiser or assessor in arriving at fair market value in money may use different factors in determining the classifications best suited to arrive at fair market value in money as defined in this section. The director of property valuation shall as soon as possible prescribe forms for the county assessing officer of each county to assist them in making such classification and subclassification of property and to properly arrive at the fair market value in money of the property. To achieve greater uniformity in the appraisal of all real property, the director of property valuation is authorized and directed to meet with county assessors, appraisers, and interested property owners in area meetings embracing as many counties as the director deems advisable for the purpose of developing

regional guidelines to be used in the appraisal of all classes of real property. [L. 1963, ch. 460, § 4; L. 1965, ch. 515, § 1; L. 1969, ch. 433, § 10, July 1.]

K.S.A. 79-1436a. Same; classification of property by director; register of deeds to report classification of property sold. The director of property valuation in carrying out his duties under the assessment ratio study of real estate sales act (K.S.A. 1965 Supp. 79-1435 *et seq.*), is authorized and directed to provide for classification of properties which are sold, transferred or contracted to be sold or transferred. Real estate shall be classified as urban or rural property. Urban property shall be subclassified as residential, multifamily, commercial, industrial or vacant lot. Rural property shall be subclassified as agricultural investment, agricultural noninvestment, home sites, planned subdivisions, spot industrial and commercial and recreational. The director of property valuation shall require the register of deeds to show on forms provided therefor, the classification and subclassification, if any, of the property sold and the classification and subclassification, if any, after the transfer is effected. [L. 1967, ch. 489, § 3; L. 1969, ch. 435, § 1; July 1.]

K.S.A. 79-1436b. Same; deviation of classification of property; director to order reappraisal. In taxable years commencing after December 31, 1971, whenever the director of property valuation shall determine that the coefficient of deviation for any one classification or subclassification of property in a county, as shown from the ratio studies, is greater than 20, he is authorized and directed to order all property within the classification or subclassification within such county to be reappraised. [L. 1969, ch. 435, § 2; July 1.]